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AGENDA ITEM 7

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Policy Review and Consolidation Project – Revision to Real Estate Policies (Second Reading)
- II. PROGRAM:** Real Estate
- III. RECOMMENDATION:** Recommend to the Investment Committee approval of the Statement of Investment Policy for Real Estate
- IV. ANALYSIS:**

Background

A comprehensive policy review was indicated as part of the Real Estate Strategic Plan recommended by the Board's real estate consultant ("Real Estate Consultant"), PCA Real Estate Advisors, Inc., and adopted by the Investment Committee in September 2007.

The Strategic Plan directed staff to review current assumptions concerning the portfolio in light of global investment conditions and determine where investment policies should be modified to reflect the new investment approach outlined in the Strategic Plan. Staff was also directed to bring revised policies to the Investment Committee, via the Policy Subcommittee, including establishing Value-Added and Opportunistic investment categories, as part of the Strategic Plan implementation timeline.

In addition to the Strategic Plan Implementation Item, existing Real Estate policies were previously scheduled for review as part of the overarching Investment Office Policy Review and Consolidation Project. This Project is a joint effort and includes input from the General Pension Consultant, the Real

Estate Consultant, the CalPERS Legal Office, and the Office of Enterprise Compliance.

In October 2008 Staff presented a new overarching policy draft to the Policy Subcommittee for first reading review and comment. Policy Subcommittee members directed a number of questions and comments to Staff and the Real Estate Consultant to consider and incorporate prior the policy's second reading.

First Reading Issues

Staff and the Real Estate Consultant have reviewed and discussed Member questions and comments from first reading and Staff recommends changes to the policy draft as highlighted in blackline format in Attachment 1.

The following is a summary of the major issues raised by the Policy Subcommittee during the October 2008 first reading with references to the applicable policy section:

1. Waivers or Exceptions (Section I)

Subcommittee's Concerns: The Subcommittee is not interested in seeing waivers or exceptions allowed in policy.

Staff Comments: No waivers or exceptions are allowed in the draft policy. To emphasize this point, the following language was added to Section I: "Only the Committee has authority to waive any provision of this Policy."

2. Staff Responsibilities (Section III A)

Subcommittee's Concerns: Deviations to Policy should be "headlined in red". Cure periods of 1 to 3 years are excessive.

Staff Comments: Staff is required to report to the Investment Committee when the portfolio is out of compliance at the next meeting or sooner if deemed necessary. Additionally, to address situations when deviations from policy occur due to market conditions, language has been added requiring Staff to report quarterly the status of the portfolio with respect to policy ranges and limits. This report will include a summary of a corrective plan and timeline to return the portfolio to compliance should the portfolio fall out of compliance with Key Policy Parameters.

3. Real Estate Consultant Responsibilities (Section III B)

Subcommittee's Concerns: What is the Real Estate Consultant's responsibility in individual investment decisions including evaluation,

approval, and recommendations? In general, what are the Real Estate Consultant's responsibilities?

Staff Comments: Extensive language was added to Section III B(4), requiring the Real Estate Consultant to report to the Investment Committee quarterly their comments on performance, diversification, leverage, policy issues, and investment transactions. Language was added to Section III B(1), mandating the Real Estate Consultant's role in the investment selection process.

4. Diversification and Limits (Section V E)

Subcommittee's Concerns: What is the purpose of the wide ranges of the risk classifications? Would it be prudent to consider a target for each risk classification? Should Staff consider establishing a higher minimum percentage in Core?

Staff Comments: The Strategic Plan establishes a target for each risk classification. The current targets were reported to the Investment Committee in September 2009 (closed session). Under the new policy, Staff will be required to report on progress toward the targets quarterly. With respect to ranges for the risk categories, the ranges were designed to have a tighter range for the higher risk categories and a wider range for the lowest risk category, Core. Staff recommends the minimum range for the Core risk classification be kept at 20%. With the current Core target per the Strategic Plan, a change to a higher minimum percentage would leave little range for fluctuations.

5. Investment Selection (Section VIII)

Subcommittee's Concerns: What is the investment selection process? Policy monitoring by the Real Estate Consultant seems to be after the fact.

Staff's Comments: The Real Estate Delegation Resolution (Attachment 2) outlines the investment selection process for Real Estate. For clarity, the investment selection process is also outlined in Section VIII B. This process requires (1) Senior Investment Officer approval, (2) review and participation by the Real Estate Consultant including documentation of comments, (3) an Independent Fiduciary concurring opinion, (4) a Real Estate Policy and Delegation Resolution compliance review by the Real Estate Consultant, and (5) a Legal Office review documenting compliance with Delegation Resolution authority.

6. **Loan Guarantees (Section X D)**

Subcommittee's Concerns: There is no time limit for loan guarantees in the policy.

Staff Comments: Time limits were added for all loan guarantees and credit enhancements. For affordable housing, work force housing, and community development investments, guarantees shall not exceed 30 years. For all other investments, guarantees shall not exceed 10 years.

7. **Other Changes**

In addition to revisions to address the Subcommittee's concerns Staff made several other material changes to the first reading draft of the policy as summarized below:

- a. **Leverage.** Added a minimum Debt Service Coverage Ratio of 1.50 for the Core risk classification.
- b. **Staff Internal Procedure Manual.** Added language requiring any changes to the manual to be allowed only with the Senior Investment Officer's and Real Estate Consultant's approval. Additionally, Staff shall annually conduct a review of the manual to ensure the manual complies with industry best business practices.
- c. **Performance Measurement.** The performance measurement section has been revised to reflect that related policy requirements will be prepared in accordance with the Statement of Investment Policy for Real Estate Appraisal and Valuation. The Investment Office is scheduled to bring a revised Real Estate Appraisal and Valuation Policy to the Policy Subcommittee in February 2009.

Policy Compliance

Subcommittee members also voiced general concern regarding policy compliance and enforcement. In addition to the specific changes outlined above, Staff will continue to work in cooperation with the Office of Enterprise Compliance (ECOM) for matters related to policy compliance, enforcement, and monitoring. ECOM has a team dedicated to investment related compliance who are responsible for oversight of the entire CalPERS Investment Portfolio including Real Estate. Real Estate Staff have worked in conjunction with ECOM regarding compliance related input during the development phase of the new Real Estate portfolio database (AREIS Project). ECOM is currently engaged in a comprehensive review of industry best practices related to Real Estate investment compliance and is scheduled to issue its report during the first quarter

2009. Staff will work in cooperation with ECOM after the release of its report to assist the division with development of an ongoing independent compliance monitoring program.

Consultants' Concurrence

The Real Estate Consultant, PCA Real Estate Advisors, Inc., and General Pension Consultant, Wilshire, have provided review and concurrence letters on proposed Staff changes (Attachments 3 and 4 respectively).

Transitioning to New Policy

Upon adoption of this policy, Staff and the Real Estate Consultant will review the portfolio for compliance with this policy. In order to comply with policy, the AREIS Database Project will need to be implemented and fully operational. The expected AREIS implementation date is second quarter 2009. Additionally, existing operating agreements will need to be reviewed to ensure compliance with the new policy. The proposed policy also calls for creation of a new Staff Internal Procedures Manual.

Staff and Board's Real Estate Consultant will recommend to the Investment Committee that the Committee engage an independent third-party consultant to complete the existing operating agreement review and oversee and assist with development of the Staff Internal Procedure Manual.

Implementation Timeline

The following timeline outlines the steps Staff is proposing to complete the Policy Review and Consolidation Project. Given the breadth of changes discussed in first reading, Staff has added a third reading and revised the timeline accordingly:

Implementation Action	Expected Timing
Staff submits policy draft to PSC to begin Board review process.	Completed (1 st Reading)
Staff submits policy draft to PSC for additional review and comment.	December 2008 (2 nd Reading)
Staff submits policy draft to PSC for additional review and comment.	February 2009 (3 rd Reading)
Real Estate Staff and LEGO complete analysis of Hazardous Waste risks and placement of mitigations in policy or procedures.	February 2009

INVO Operations Staff submit proposed policies for Real Estate Accounting and Real Estate Appraisal and Valuation to the PSC for review and comment.	February 2009
Staff submits proposed policy to Investment Committee upon approval of PSC.	March 2009
Staff submits revised Real Estate Delegation to Investment Committee for review and approval.	March 2009
Staff recommends to Investment Committee engagement of an independent third-party consultant to: <ol style="list-style-type: none"> (1) Complete review of existing operating agreement for compliance with new policy; and (2) Oversee and assist with development of Staff Internal Procedure Manual. 	March 2009
INVO Operations Staff submit proposed policies for Real Estate Accounting and Real Estate Appraisal and Valuation to the Investment Committee upon approval of PSC.	March 2009
Staff submits updated Attachment A (For Sale Residential and Land Development) to PSC for review and comment.	April 2009
Staff submits updated Attachment B (CURE) to PSC for review and comment.	June 2009
Independent third-party consultant completes review of existing operating agreements for compliance with new policy and submits findings to the Investment Committee.	June 2009
Independent third-party consultant and Staff complete development of Staff Internal Procedure Manual.	September 2009

V. STRATEGIC PLAN:

The Real Estate Policy Review and Consolidation Project will further the following CalPERS Strategic Plan goals:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

There are no material costs associated with this agenda item.

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